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MEMORANDUM FOR: OEA -
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FYI -- A good article. Any comments?

Maurice Ernst
NIO/Econ

Date 29 June 1982

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E.O. 12065: N/A
TAGS: EFIN, JA
SUBJECT: A JAPANESE VIEW OF EXCHANGE RATE POLICY

1. SUMMARY. THIS MESSAGE TRANSMITS THE TEXT OF AN ADVANCE COPY OF AN ARTICLE ENTITLED "A JAPANESE VIEW OF EXCHANGE RATE POLICY" WRITTEN BY BANK OF JAPAN EXECUTIVE DIRECTOR SHIJURO OGATA THAT EMBASSY COMMENDS TO THE ATTENTION OF WASHINGTON AGENCIES INTERESTED IN THE SUBJECT AS BOTH COMPREHENSIVE AND READABLE. IT WAS PROVIDED TO FINATT BY THE SWISS EMBASSY HERE IN TOKYO. THE SWISS EMBASSY TELLS US THAT THE ARTICLE WAS PREPARED BY OGATA AT SWISS REQUEST FOR A SPECIAL EDITION ON MONETARY QUESTIONS OF THE (USUALLY) MONTHLY PUBLICATION AUSSENWIRTSCHAFT OF THE UNIVERSITY OF ST. GALLEN. THE SPECIAL EDITION ON MONETARY QUESTIONS WILL BE PUBLISHED SOMETIME IN JULY, AND IT WOULD PRESUMABLY BE APPRECIATED IF THE FOLLOWING TEXT WERE TREATED AS EMBARGOED UNTIL PUBLICATION. END SUMMARY.

BEGIN TEXT.

I. INTRODUCTION

- WHEN THE BRETTON WOODS SYSTEM OF FIXED EXCHANGE RATES FINALLY COLLAPSED IN MARCH OF 1973, THOSE WHO HAD ADVOCATED A FLOATING EXCHANGE RATE SYSTEM TRIUMPHANTLY PREDICTED THAT:

- A) FLOATING EXCHANGE RATES WOULD AUTOMATICALLY BRING COUNTRIES' EXTERNAL BALANCES INTO EQUILIBRIUM;

- B) MARKET FORCES WOULD ENSURE A SMOOTH AND FLEXIBLE ADJUSTMENT OF EXCHANGE RATES; AND

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C) COUNTRIES WOULD BE FREE OF EXTERNAL CONSTRAINTS SO THAT THEY COULD PURSUE DOMESTICALLY-ORIENTED MONETARY AND FISCAL POLICIES.

TODAY, NINE YEARS SINCE THEN, WE SEE TWO DIAMETRICALLY OPPOSED ATTITUDES IN EUROPE AND THE UNITED STATES CONCERNING EXCHANGE RATE MANAGEMENT. IN EUROPE, A FIXED BUT ADJUSTABLE EXCHANGE RATE REGIME WAS PARTIALLY RESTORED FOR THE MAJOR CURRENCIES, EXCEPT THE POUND STERLING, IN THE FORM OF THE EUROPEAN MONETARY SYSTEM. THIS SYSTEM, STARTED IN MARCH 1979, AIMS AT CREATING "A ZONE OF MONETARY STABILITY IN EUROPE." THE CRUCIAL MOTIF FOR THIS, AS I UNDERSTAND IT, WAS THE RECOGNITION THAT MARKET FORCES COULD SOMETIMES PRODUCE VERY UNREALISTIC EXCHANGE RATES WHICH ARE NOT TOLERABLE FOR THE PARTICIPATING COUNTRIES THAT ARE DEPENDENT UPON EACH OTHER TO A SIGNIFICANT EXTENT. FROM THIS RECOGNITION, THEY ARE READY TO ACCEPT STRONG CONSTRAINTS ON THEIR POLICIES IMPOSED BY FIXED EXCHANGE RATES.

AT THE OTHER EXTREME, THE PRESENT U.S. ADMINISTRATION INTENDS TO INTERVENE IN THE EXCHANGE MARKET ONLY IN CRISIS SITUATIONS. THIS IS A CLEAR REVERSAL OF THE POLICY ANNOUNCED BY PRESIDENT CARTER IN NOVEMBER 1978, WHEREBY THE UNITED STATES DEMONSTRATED ITS WILLINGNESS TO "CORRECT" THE UNDERVALUATION OF THE DOLLAR BY INTERVENING MASSIVELY IN THE MARKET, IN COOPERATION WITH THE CENTRAL BANKS OF GERMANY, SWITZERLAND AND JAPAN. IT MAY BE RECALLED THAT THE UNITED STATES NOT ONLY ENLARGED SWAP NETWORKS BUT ALSO ISSUED SO-CALLED "CARTER BONDS" TO OBTAIN NECESSARY FOREIGN EXCHANGE. IN SHARP CONTRAST, THE PRESENT ADMINISTRATION BASICALLY BELIEVES THAT THE MARKET KNOWS BEST, AND HAS RETURNED TO THE PRE-1978 CONCEPT OF MINIMAL INTERVENTION.

WHERE DOES JAPAN STAND BETWEEN THESE TWO EXTREMES? IN TRYING TO ANSWER THIS QUESTION AND TO EXPLAIN EXCHANGE RATE POLICY OF THE BANK OF JAPAN, THIS PAPER FIRST PRESENTS A VERY BRIEF REVIEW OF OUR NINE YEARS' EXPERIENCE WITH THE FLOATING YEN, WITH A VIEW TO ASSESSING THE LESSONS WE CAN LEARN FROM IT (SECTION II). IT THEN DESCRIBES THE PRINCIPLES OF OUR EXCHANGE RATE MANAGEMENT

WHICH ARE DERIVED FROM THESE LESSONS, PLACING EMPHASIS ON OUR THINKING WITH REGARD TO THE EFFECTIVENESS OF OFFICIAL INTERVENTION (SECTION III).

II. NINE YEARS' EXPERIENCE WITH THE FLOATING YEN AND THE LESSONS WE HAVE LEARNED.

1. FOUR EPISODES IN THE HISTORY OF THE FLOATING YEN

SINCE THE TRANSITION TO FLOATING IN 1973, WE HAVE EXPERIENCED WIDE AND FREQUENT FLUCTUATIONS IN THE YEN EXCHANGE RATE. WHILE NOT INTENDING TO MAKE A THOROUGH REVIEW, I SHOULD LIKE TO PICK UP FOUR EPISODES, THE LESSONS FROM WHICH HAVE INFLUENCED OUR THINKING AND ARE THEREFORE THE BASIS FOR OUR PRESENT POLICY.

THE FIRST EPISODE IS THE DECLINE OF THE YEN IN THE PERIOD RIGHT AFTER THE FIRST OIL CRISIS. THE YEN DEPRECIATED FROM YEN 265 TO THE DOLLAR IN OCTOBER 1973 TO YEN 307 IN DECEMBER 1975 OWING TO THE RAPID RATE OF INFLATION IN JAPAN AND A LARGE DEFICIT IN OUR CURRENT ACCOUNT BALANCE OF PAYMENTS, AMOUNTING TO $4.7 BILLION IN 1974. WHAT IS STRIKING IN THIS EPISODE WAS THAT NO STABILIZING CAPITAL INFLOW TO FINANCE THE CURRENT DEFICIT WAS FORTH-

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COMING, CONTRARY TO THE PREDICTION BY THE PROPONENTS OF FLOATING. THE CAPITAL ACCOUNT ACTUALLY RECORDED A DEFICIT OF $2.1 BILLION IN THAT YEAR. AS A RESULT, THERE WAS A LARGE DEFICIT IN THE OVERALL ACCOUNT, WHICH WAS FIRST FINANCED BY THE DECLINE IN RESERVES AND THEN BY THE DETERIORATION IN THE BANKS' EXTERNAL POSITION.

- ALTHOUGH OUR CURRENT AND CAPITAL ACCOUNT DEFICITS BEGAN TO DECREASE IN 1975, IT WAS NOT UNTIL THE BEGINNING OF 1976 THAT THE YEN STARTED TO APPRECIATE, BY WHICH TIME THE CURRENT ACCOUNT HAD TURNED INTO A SURPLUS.

- THE SECOND EPISODE CONCERNS THE YEN'S SHARP APPRECIATION FROM AROUND YEN 260-270 TO THE DOLLAR IN MID-1977 TO YEN 176 IN OCTOBER 1978. THE U.S. DOLLAR SHOWED A DRAMATIC DECLINE IN THIS PERIOD, AND THE YEN'S APPRECIATION WAS ONE OF THE MOST STRIKING. IT IS TRUE THAT AN UPWARD ADJUSTMENT IN THE YEN EXCHANGE RATE WAS NEEDED BECAUSE THE JAPANESE CURRENT ACCOUNT WAS SHOWING LARGE SURPLUSES, TOTALING $27.4 BILLION IN 1977 AND 1978, AND THE U.S. CURRENT ACCOUNT RECORDING LARGE DEFICITS. BUT, THE MAGNITUDE AND THE SPEED OF THE CHANGE WAS MUCH TOO EXCESSIVE BY ANY STANDARDS. WITH DOLLAR SELLING FUELLING ON ITSELF, WE HAD TO INTERVENE HEAVILY IN THE MARKET, BUT OUR EFFORTS, INCLUDING OTHER MEASURES SUCH AS REDUCTIONS IN THE OFFICIAL DISCOUNT RATE AND CONTROLS ON CAPITAL INFLOW, DID NOT ACHIEVE MUCH UNTIL THE U.S. AUTHORITIES ANNOUNCED THEIR INTENTION OF "CORRECTING" THE EXCESSIVE UNDERVALUATION OF THE DOLLAR ON 1ST NOVEMBER, 1978 AND FOLLOWED THIS THROUGH BY INTERVENING FORCEFULLY IN THE MARKET.

- THE THIRD EPISODE WAS THE DECLINE OF THE YEN FROM LATE 1978 TO THE FIRST QUARTER OF 1980, FROM THE PEAK OF YEN 176 IN LATE OCTOBER 1978 TO YEN 260 IN EARLY APRIL 1980. THIS PLUNGE WAS DUE TO MARKETS' BELIEF THAT JAPAN WAS THE MOST VULNERABLE AMONG INDUSTRIALIZED COUNTRIES TO THE SECOND OIL CRISIS, AND THE YEN LOST GROUND AGAINST MOST MAJOR EUROPEAN CURRENCIES AS WELL. AS IN THE PREVIOUS CASE, CAPITAL FLOWS AGGRAVATED THE DIFFICULTY: WHEN THE CURRENT ACCOUNT RECORDED A $8.8 BILLION DEFICIT IN 1979, THE CAPITAL ACCOUNT WAS ALSO IN THE RED TO THE TUNE OF $7.9 BILLION, AND THE GAP WAS MOSTLY FILLED BY OUR INTERVENTION.

- THE FOURTH EPISODE STARTED IN THE BEGINNING OF 1981 AND IS CONTINUING AT THE TIME OF WRITING. FROM THE RECENT PEAK OF YEN 199.60 IN JANUARY 1981, THE YEN HAS BEEN GRADUALLY WEAKENING TO AROUND YEN 245 IN MID-APRIL 1982. THIS IS NOT SO MUCH DUE TO ANY PARTICULAR WEAKNESS OF THE YEN BUT SIMPLY THE DOLLAR'S OVERALL STRENGTH: AGAINST THE DEUTSCHE MARK, FOR EXAMPLE, THE YEN HAS BEEN FAIRLY STABLE AT AROUND YEN 100 TO THE DM. IN VIEW OF OUR STRONG EXTERNAL POSITION, REFLECTED IN A $4.7 BILLION CURRENT ACCOUNT SURPLUS IN 1981, AND THE LOWEST RATE OF INFLATION AMONG MAJOR COUNTRIES, THE PRESENT WEAKNESS OF THE YEN IS VERY MUCH DIFFERENT FROM THAT IN THE PAST EPISODES DESCRIBED ABOVE. THE MAJOR CAUSE FOR THE CURRENT WEAKNESS

IS THE LARGE-SCALE OUTFLOW OF LONG-TERM CAPITAL, AMOUNTING TO $9.7 BILLION IN 1981, INDUCED BY THE UNPRECEDENTED WIDTH IN INTEREST RATE DIFFERENTIALS BETWEEN JAPAN AND THE UNITED STATES. MOREOVER, U.S. INTEREST RATES HAVE NOT ONLY BEEN VERY HIGH BUT ALSO QUITE VOLATILE, AND THIS SEEMS TO HAVE DIVERTED MARKET PARTICIPANTS' ATTENTIONFROM MORE FUNDAMENTAL FACTORS. CONSEQUENTLY, OUR EFFORTS TO STEM THE SLIDE OF THE YEN THROUGH MARKET INTERVENTION HAVE NOT BEEN VERY SUCCESSFUL.

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- 2. LESSONS WE HAVE LEARNED FROM OUR EXPERIENCE
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- WHAT ARE THE LESSONS WE HAVE LEARNED FROM OUR EXPERIENCE, AND WHAT CAN WE SAY ABOUT THE MODUS OPERANDI OF THE FLOATING YEN?
- FIRST, THE VOLATILITY OF EXCHANGE RATES HAS INCREASED, CONTRARY TO WHAT ADVOCATES OF THE FLOATING RATE SYSTEM PREDICTED. MOREOVER, THIS VOLATILITY SEEMS TO BE INCREASING, INSTEAD OF DECREASING, IN MORE RECENT YEARS. MARKETS TEND TO OVERREACT WHEN THEY ENCOUNTER EXTERNAL SHOCKS AND MAJOR POLICY CHANGES. AND, CAPITAL FLOWS, WHICH HAVE BEEN EXPECTED TO STABILIZE EXCHANGE RATE MOVEMENTS, OFTEN, IN FACT, AMPLIFY SUCH MOVEMENTS, AS CLEARLY DEMONSTRATED IN THE EPISODES FOLLOWING THE TWO OIL SHOCKS. THIS HAS RESULTED IN THE SERIOUS "OVERSHOOTING" OF MANY CURRENCIES, NOT LEAST THE YEN.
- SECOND, COUNTRIES' EXTERNAL BALANCES ARE NOT AUTOMATICALLY BROUGHT INTO EQUILIBRIUM BY FLOATING RATES, AT LEAST NOT IN A SHORT PERIOD OF TIME. THIS IS CLEAR FROM THE DIFFICULTIES SOME COUNTRIES ARE HAVING FINANCING THEIR DEFICITS AND ALSO FROM THE MOUNTING PROBLEM OF TRADE FRICTION.
- THE THIRD LESSON, WHICH IS RELATED TO THE FIRST AND THE SECOND, IS THAT EXCHANGE RATES DO NOT ALWAYS MOVE AS DICTATED BY "FUNDAMENTALS" SUCH AS COUNTRIES' RELATIVE PERFORMANCE IN PRICE STABILITY, GROWTH AND THEIR CURRENT ACCOUNT POSITIONS. JUDGING FROM OUR EXPERIENCE, THE CURRENT ACCOUNT BALANCE OF PAYMENTS HAS GENERALLY BEEN A DOMINANT FACTOR IN DETERMING THE YEN RATE, BUT EVEN THIS RELATIONSHIP HAS BECOME LESS CLEAR IN THE RECENT PAST BECAUSE OF, AMONG OTHER THINGS, THE PRESENCE OF WIDE INTEREST DIFFERENTIALS. THE EFFECTS OF INTEREST DIFFERENTIALS ON EXCHANGE RATES ARE SUPPOSED, IN THEORY, TO WORK THEMSELVES OUT QUICKLY, AND, THEREFORE, NO LASTING EFFECTS ARE EXPECTED. IN REALITY, HOWEVER, THE HIGH AND VERY VOLATILE INTEREST RATES ABROAD HAVE ERODED ANY CERTAINTY UPON WHICH THE MARKET CAN FORM EXPECTATIONS AS TO THE FUTURE. IT IS AGAINST THIS GENERALLY UNCERTAIN MARKET OUTLOOK THAT WIDE INTEREST DIFFERENTIALS HAVE CONTINUED TO DEPRESS THE YEN.
-
- THE "OVERSHOOTING" OF EXCHANGE RATES CAUSES OVERCORRECTION IN EXTERNAL ACCOUNTS, AFFECTS DOMESTIC ECONOMIC ACTIVITIES PROFOUNDLY, AND MAY RESULT IN THE SERIOUS MISALLOCATION OF RESOURCES. IF THE MARKET SOMETIMES BRINGS ABOUT SUCH "OVERSHOOTING" WHEN LEFT ALONE, EXTERNAL CONSTRAINTS STILL EXIST AND HAVE TO BE CONSIDERED IN THE FORMULATION OF MONETARY POLICY, TO WHICH WE NOW TURN.
-
III. EXCHANGE RATE POLICY OF THE BANK OF JAPAN
-
- 1. BASIC STRATEGY
-
- AS SHOWN IN THE PREVIOUS SECTION, WE CANNOT BUT HAVE AN EXCHANGE RATE POLICY. OUR BASIC STRATEGY IN THIS CAN BE CONVENIENTLY SUMMARIZED UNDER THE FOLLOWING THREE HEADINGS:
-
- (A) NON-EXISTENCE OF A TARGET RANNE
-
- ALTHOUGH WE DO HAVE AN EXCHANGE RATE POLICY, WE HAVE NEVER HAD ANY EXCHANGE RATE TARGET SINCE THE YEN'S TRANSITION TO FLOATING IN FEBRUARY 1973, AND THIS IS WHERE OUR ATTITUDE IS CLEARLY DIFFERENT FROM THAT OF EMS PARTICIPATING COUNTRIES. SINCE THE EXCHANGE RATE OF A CURRENCY IS ITS VALUE IN TERMS OF OTHER CURRENCIES, IT IS EXTREMELY DIFFICULT FOR THE AUTHORITIES TO MAINTAIN A TARGET RATE FOR ITS CURRENCY WITHOUT

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- HAVING STABLE ECONOMIC RELATIONS WITH OTHER MAJOR
- COUNTRIES. THE PRIMARY PREREQUISITES FOR A TARGET
- RATE FOR THE YEN ARE THEREFORE: (1) THE EXISTENCE

- OF FUNDAMENTAL EQUILIBRIUM BETWEEN JAPAN AND HER
- MAJOR TRADING PARTNERS BOTH IN TERMS OF INFLATION
- AND BALANCE OF PAYMENTS; (2) THE WILLINGNESS BOTH
- ON OUR PART AND ON THE PART OF OUR MAJOR PARTNERS
- TO COOPERATE CLOSELY IN THE FIELD OF ECONOMIC
- POLICIES IN ORDER TO ATTAIN BETTER EQUILIBRIUM;
- AND (3) IN THE ABILITY ON BOTH SIDES TO AGREE ON A
- PROMPT REVISION OF THE ESTABLISHED TARGET, WHEN
- IT BECOMES CLEAR THAT THE EXISTING DISEQUILIBRIA
- CANNOT BE CORRECTED UNDER THE ESTABLISHED TARGET
- RATE. I AM AFRAID THAT THESE PREREQUISITES NOT
- ONLY DO NOT EXIST AT PRESENT BUT ARE ALSO NOT
- EXPECTED TO EMERGE IN THE NEAR FUTURE.
-
- FURTHERMORE, WE HAD A BITTER EXPERIENCE TRYING
- TO DEFEND THE FIXED EXCHANGE RATE SYSTEM AFTER THE
- "NIXON SHOCK." THE BANK OF JAPAN BOUGHT A HUGE
- AMOUNT OF DOLLARS IN THE TOKYO MARKET, AND THIS LED
- TO A SHARP INCREASE IN MONEY SUPPLY AND EVENTUALLY
- TO A VERY HIGH RATE OF INFLATION. WITH HINDSIGHT,
- THE YEN RATE WHICH WE TRIED TO DEFEND WAS QUITE
- UNREALISTIC, AND, THE YEN SHOULD HAVE BEEN ALLOWED
- TO APPRECIATE MUCH EARLIER. THE MEMORY OF THIS HAS
- MADE US QUITE RELUCTANT TO ADOPT AN EXCHANGE RATE
- TARGET.
-
- THIS IS NOT TO SAY THAT WE ARE CYNICAL ABOUT THE
- EMS. PARTICIPANTS OF THE EMS SHARE A LARGE MARKET
- WHERE CAPITAL AND LABOUR CAN MOVE FREELY, AND THE
- MUTUAL INTERDEPENDENCE OF THEIR ECONOMIES IS MUCH
- GREATER THAN THAT BETWEEN OUR ECONOMY AND THOSE OF
- OUR MAJOR TRADING PARTNERS. IT IS THEREFORE QUITE
- NATURAL THAT THEY SHOULD BE READY TO ACCEPT GREATER
- COSTS FOR A FIXED BUT ADJUSTABLE EXCHANGE RATE REGIME.
-
- (B) RECOGNITION OF THE SIGNIFICANCE OF MAINTAINING
- GOOD ECONOMIC PERFORMANCE
-
- NINE YEARS' EXPERIENCE HAS TAUGHT US THAT
- MAINTAINING GOOD "FUNDAMENTALS"--GOOD PERFORMANCE
- REGARDING PRICES, BALANCE OF PAYMENTS AND GROWTH
- --IS THE VERY PREREQUISITE FOR SECURING A STRONG
- AND STABLE CURRENCY. BROADLY SPEAKING, THE YEN
- HAS REFLECTED OUR RELATIVE STRENGTH IN THESE
- FACTORS. REGRETTABLY, HOWEVER, MARKETS DO NOT
- ALWAYS CONCENTRATE ON "FUNDAMENTALS", AS THEIR
- ATTENTION CAN BE DIVERTED BY SUCH FACTORS AS HIGH
- AND VOLATILE INTEREST RATES ABROAD AND AN UNCERTAIN
- INTERNATIONAL POLITICAL OUTLOOK. THIS IS PRECISELY
- WHAT IS HAPPENING TO THE YEN RATE AT THE MOMENT
- OF WRITING (APRIL 1982). THE YEN HAS BECOME TOO
- LOW IN OUR JUDGMENT, JEOPARDISING PRICE STABILITY
- AND AGGRAVATING TRADE FRICTIONS. SO, MAINTAINING
- GOOD ECONOMIC PERFORMANCE IS A NECESSARY,
- BUT NOT SUFFICIENT, CONDITION FOR A STRONG YEN.
-
- (C) EXCHANGE RATE POLICY IN THE FRAMEWORK OF OUR
- OVERALL MONETARY MANAGEMENT
-
- I HAVE WRITTEN EARLIER THAT A CENTRAL BANK MUST
- HAVE AN EXCHANGE RATE POLICY. THAT DOES NOT MEAN,
- THOUGH, THAT SUCH A POLICY IS INDEPENDENT FROM
- DOMESTIC MONETARY POLICY. RATHER, IT IS AN INTEGRAL
- PART OF OUR OVERALL MONETARY MANAGEMENT. I MIGHT
- MENTION IN THIS CONNECTION THAT THE BANK OF JAPAN

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- IS BECOMING INCREASINGLY AWARE OF THE IMPORTANCE
- OF CONTROLLING MONETARY AGGREGATES IN ITS CONDUCT
- OF MONETARY POLICY, BUT THIS DOES NOT MEAN THAT WE
- ARE PAYING LESS ATTENTION TO EXCHANGE RATE MOVEMENTS
- THAN BEFORE. INDEED, THE TWO OBJECTIVES ARE OFTEN
- COMPLEMENTARY: WHEN MONETARY AGGREGATES ARE UNDER
- GOOD CONTROL AND RESULT IN STABLE PRICES, WE USUALLY
- SEE A STABLE YEN, AND WHEN THE YEN EXCHANGE RATE IS
- STABLE, IT IS EASIER FOR US TO PURSUE A STEADY
- MONETARY COURSE.
-
- AT TIMES, HOWEVER, WHEN THE YEN EXCHANGE RATE MOVES
- CLEARLY OUT OF LINE WITH THE FUNDAMENTAL FACTORS
- MENTIONED EARLIER, CONSIDERATION REGARDING THE YEN
- EXCHANGE RATE CAN BECOME A DOMINANT FACTOR IN OUR
- POLICY DELIBERATIONS. FOR EXAMPLE, WE HAD TO RAISE
- OUR OFFICIAL DISCOUNT RATE BY A TOTAL OF 2.75 PER-

- CENTAGE POINTS TO THE RECORD-LEVELLING 9.0 PERCENT
- IN THE FIRST QUARTER OF 1980 BECAUSE THE YEN
- DEPRECIATED EXCESSIVELY, AND THAT THREATENED TO FUEL
- DOMESTIC INFLATION. MEASURES WERE ALSO TAKEN TO
- ENCOURAGE CAPITAL INFLOWS, AND THE SIZE OF INTER-
- VENTION WAS INCREASED. IT MAY BE NOTED THAT THE
- RATE OF INCREASE IN MONEY STOCK HAD ALREADY BEEN
- SLOWING DOWN BY THAT TIME, SO THAT THIS EPISODE
- IS A CLEAR DEMONSTRATION OF THE FACT THAT WE DO
- NOT REGARD THE EXCHANGE RATE AS A RESIDUAL GIVEN
- BY DOMESTICALLY-ORIENTED MONETARY AND FISCAL
- POLICIES.
-
- ANOTHER INDICATION THAT EXCHANGE RATE CONSIDERATIONS
- CAN BE A DOMINANT FACTOR IN OUR POLICY FORMULATIONS
- IS THE INTRODUCTION IN MARCH 1981 OF OUR VERSION OF
- SPECIAL LOMBARD FACILITY. IF A SITUATION ARISES WHEN
- SHORT-TERM CAPITAL OUTFLOWS EXERT STRONG DOWNWARD
- DISCOUNT RATE IS DEEMED INAPPROPRIATE, THIS FACILITY
- CAN BE ACTIVATED AS A CONTINGENT MEASURE FOR A SHORT
- PERIOD OF TIME. IT IS OUR VIEW THAT OUR GRIP ON
- MONEY MARKET INTEREST RATES WAS SIGNIFICANTLY ENHANCED
- BY THIS FACILITY.
-
- ALTHOUGH THIS SPECIAL FACILITY HAS NOT BEEN
- ACTIVATED YET, THE BANK OF JAPAN HAS MADE SHORT-TERM
- MONEY MARKET RATES FIRMER, BY ABSORBING EXCESS
- LIQUIDITY, DURING THE MOST RECENT PHASE OF THE YEN'S
- DEPRECIATION. THIS RECENT ACTION IS INTENDED TO
- ELIMINATE ANY MARKET EXPECTATIONS OF LOWER INTEREST
- RATES WHICH SEASONAL FACTORS MAY HAVE GIVEN RISE TO,
- THEREBY DEMONSTRATING OUR DETERMINATION NOT TO ALLOW
- ALREADY LARGE INTEREST RATE DIFFERENTIALS TO WIDEN.
-
2. THE ROLE OF OFFICIAL INTERVENTION
-
- TURNING TO THE MORE DIRECT TOOL OF EXCHANGE RATE
POLICY, OFFICIAL INTERVENTION IN THE EXCHANGE MARKET, WE
BELIEVE THAT IT IS A NECESSARY, THOUGH BY NO MEANS SUFFI-
CIENT, POLICY INSTRUMENT. TO SOME EXTENT, THIS CAN BE
SEEN FROM THE SIMPLE FACT THAT WHENEVER THERE WERE LARGE
IMBALANCES IN OUR BASIC BALANCE OF PAYMENTS, ACCOMMODATING
CAPITAL FLOWS WERE NOT NECESSARILY FORTHCOMING AS SHOWN
ALREADY. SINCE THERE ARE CERTAIN THEORETICAL OBJECTIONS
TO MARKET INTERVENTION, I SHOULD LIKE TO ELABORATE SOME-
WHAT ON THE QUESTION OF THE EFFECTIVENESS OF OFFICIAL
INTERVENTION. IN MY VIEW, THESE OBJECTIONS CAN BE
SUMMARIZED AS FOLLOWS:
-
- FIRST, CENTRAL BANK INTERVENTION FUELS SPECULATION
BECAUSE IT OFTEN PROVIDES RISK-FREE PROFIT OPPORTUNITIES.

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- SECONDLY, CENTRAL BANKS DO NOT KNOW THE FUTURE COURSE OF EXCHANGE RATES ANY BETTER THAN PRIVATE MARKET PARTICIPANTS, SO THAT THERE IS NO REASON WHY THE MARKET SHOULD BE MORE STABLE IF CENTRAL BANKS JOINED THE GAME.

- THIRDLY, CENTRAL BANK INTERVENTION INFLUENCES EXCHANGE RATES ONLY TO THE EXTENT IT INFLUENCES THE MONEY STOCK. THIS CRITICISM IS BASED ON THE THEORY THAT THE PRINCIPAL DETERMINANT OF EXCHANGE RATES IS THE DIFFERENCE IN THE RATES OF MONETARY GROWTH BETWEEN COUNTRIES. ACCORDING TO THIS THEORY, A CENTRAL BANK IS BETTER ADVISED TO CONCENTRATE ON CONTROLLING THE MONEY MARKET, SINCE IT CANNOT CONTROL BOTH THE EXCHANGE MARKET AND THE MONEY MARKET--ONE OF THEM HAS TO BE CLEARED AS THE RESIDUAL.

- IN ASSESSING THESE OBJECTIONS, WE DO NOT HESITATE TO ADMIT THAT THERE IS A LIMIT TO WHAT INTERVENTION CAN ACHIEVE, ESPECIALLY WHEN IT IS NOT SUPPORTED BY OTHER POLICY MEASURES AND/OR WHEN IT IS NOT COORDINATED WITH OTHER MAJOR CENTRAL BANKS. WE STILL BELIEVE, HOWEVER, THAT INTERVENTION HAS A USEFUL ROLE TO PLAY. TAKING THE FIRST OF THE ABOVE OBJECTIONS, WE FULLY APPRECIATE THE DANGER THAT INTERVENTION CAN FUEL SPECULATION, PARTICULARLY WHEN IT TRIES TO PEG THE EXCHANGE RATE AT SPECIFIC LEVELS. IT IS PRECISELY BECAUSE OF THIS FEAR THAT WE DO NOT INTERVENE AT ANY PREDETERMINED LEVEL. THERE ARE TURBULENT TIMES IN THE EXCHANGE MARKETS WHEN SPECULATION FEEDS ON ITSELF, AND THE EXCHANGE RATES MOVE FAR OUT OF LINE WITH WHAT THE "FUNDAMENTALS" WOULD WARRANT. OR, THERE ARE OTHER TIMES WHEN MARKET PARTICIPANTS BECOME

VERY UNCERTAIN AS TO THE FUTURE COURSE OF EXCHANGE RATE MOVEMENTS AFTER A PERIOD OF OVER-SHOOTING. ON THESE OCCASIONS, DETERMINED INTERVENTION BY THE CENTRAL BANK COULD SUCCESSFULLY INTRODUCE SOME INDICATION, AS TO THE DIRECTION OF THE CURRENCY, INDUCING THE MARKET TO SEEK A MORE CORRECT--OR LESS INCORRECT--LEVEL.

- CONCERNING THE SECOND TYPE OF CRITICISM, IT SHOULD BE STRESSED THAT CENTRAL BANKS ARE POWERFUL PLAYERS, AND THEIR BEHAVIOUR IS AN IMPORTANT FACTOR WHICH MARKET PARTICIPANTS TAKE INTO ACCOUNT WHEN THEY FORMULATE THEIR EXPECTATIONS. IT IS USEFUL TO LET THE MARKET KNOW OUR CONCERN AS WELL AS PREFERENCE THROUGH OUR PRESSURE IN THE MARKET. WE READILY ADMIT THAT THE AUTHORITIES ARE NO WISER THAN PRIVATE MARKET PARTICIPANTS IN KNOWING THE CORRECT LEVEL OF THE EXCHANGE RATE, BUT WE HAVE MORE INFORMATION THAN THEY HAVE TO THE EXTENT THAT WE KNOW OUR OWN COURSE OF ACTION BETTER!

- TURNING TO THE LAST TYPE OF CRITICISM REGARDING THE CONFLICT BETWEEN THE OBJECTIVES OF MONETARY CONTROL AND OF EXCHANGE RATE MANAGEMENT, IT IS WRONG TO THINK MECHANICALLY IN EITHER/OR TERMS, BECAUSE EXPECTATIONS REGARDING INTEREST RATES AND EXCHANGE RATES ARE NOT INDEPENDENT OF EACH OTHER. TO STABILIZE THE EXCHANGE RATE HELPS TO BRING MONETARY AGGREGATES UNDER BETTER CONTROL AND VICE VERSA, AS DISCUSSED ELSEWHERE. AT ANY RATE, MONETARY CONTROL AND EXCHANGE RATE MANAGEMENT ARE THE MEANS TO ACHIEVE THE FINAL GOAL, WHICH IS TO ENSURE THE STABILITY OF PRICES, EMPLOYMENT AND THE EXTERNAL BALANCE. MANAGING TWO MARKETS AT THE SAME TIME IS A KIND OF THING THAT IS POSSIBLE ONLY IN PRACTICE!

- IN THIS CONNECTION, I SHOULD LIKE TO REFER TO OUR BELIEF THAT THE EFFECTIVENESS OF INTERVENTION RESTS MORE ON ITS EFFECTS ON MARKET PSYCHOLOGY THAN ON ITS DIRECT EFFECTS ON THE SUPPLY OF OR DEMAND FOR FOREIGN EXCHANGE.

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IT FOLLOWS FROM THIS THAT IT IS QUITE NORMAL TO EXPECT THE CONCERTED ACTION OF MAJOR CENTRAL BANKS TO HAVE A BETTER CHANCE OF SUCCESS. THIS WAS AMPLY DEMONSTRATED IN LATE 1978 AND EARLY 1980.

- AT PRESENT, THERE IS A DIFFERENCE IN PHILOSOPHY ACROSS THE PACIFIC CONCERNING MARKET INTERVENTION. EVEN LEAVING THAT ASIDE, CONCERTED INTERVENTIONS REQUIRE THAT PARTNERS HAVE A SIMILAR NOTION CONCERNING AN "EQUILIBRIUM" EXCHANGE RATE." THIS, HOWEVER, MAY BE EASIER TO SOLVE IN PRACTICE THAN SEEMS AT FIRST SIGHT. TO QUOTE MR. VOLCKER'S SPEECH AT WARWICK UNIVERSITY IN 1978:

> "IT SHOULD BE POSSIBLE OVER TIME TO REACH A BROAD CONCENSUS ABOUT LEVELS OF A FEW KEY EXCHANGE RATES THAT ARE NOT ACCEPTABLE-- THAT ARE PLAINLY DISRUPTIVE OF MUTUAL OBJECTIVES."

- I MAY CALL THESE LEVELS "NEGATIVE AREAS," WHICH DO NOT HAVE TO BE SPECIFIED IN ADVANCE. AGREEMENTS COULD BE REACHED AND CHANGED FLEXIBLY THROUGH CLOSE DAILY CONTACT AMONG CENTRAL BANKS. AS DR. LEUTWILER OF THE SWISS NATIONAL BANK SAID: "THIS IS WHAT THE TELEPHONE IS FOR."

- TO SUM UP, INTERVENTION IS BY NO MEANS A "PANACEA," BUT IS A USEFUL AND INDISPENSABLE TOOL. ITS EFFECTIVENESS DEPENDS ON WHETHER IT IS SUPPORTED BY MONETARY AND OTHER ECONOMIC POLICIES, BUT THE EFFECTIVENESS CAN BE SIGNIFICANTLY ENHANCED IF IT IS CONDUCTED IN A CONCERTED MANNER BY MAJOR CENTRAL BANKS.

3. ASYMMETRY IN OUR INTERVENTION STRATEGY

- IF THE BANK OF JAPAN CONSIDERS MARKET INTERVENTION AS A NECESSARY AND USEFUL TOOL, WHAT IS THE BANK'S STRATEGY FOR USING THIS TOOL? CONCERNING THIS QUESTION, I SHOULD LIKE TO POINT OUT THAT THERE IS AN ASYMMETRY IN OUR INTERVENTION STRATEGY. WE TEND TO INTERVENE MORE VIGOROUSLY WHEN THE YEN DEPRECIATES THAN WHEN IT APPRECIATES, BECAUSE OF THE UNFAVOURABLE IMPACT OF DEPRECIATION ON DOMESTIC PRICES. TAKING THE MOST RECENT SWING IN THE YEN RATE AS AN EXAMPLE, WE INTERVENED MUCH LESS IN THE PERIOD UP TO THE END OF 1980, BY WHICH TIME THE YEN HAD RISEN TO YEN 200 TO THE DOLLAR, THEN IN THE PERIOD SINCE THEN, WHEN THE YEN GRADUALLY DECLINED TO ABOUT YEN 245 IN LATE APRIL 1982. THIS STRATEGY OF OURS HAS BROAD SUPPORT, NOT ONLY FROM CONSUMERS BUT ALSO FROM INDUSTRIES.

- HISTORICALLY, BUSINESS COMMUNITY HAS NOT WELCOMED THE YEN'S APPRECIATION. WHEN THE YEN ROSE SHARPLY AFTER THE "NIXON SHOCK" AND ALSO IN 1978, JAPANESE INDUSTRIES WERE QUITE WORRIED ABOUT ITS DEFLATIONARY IMPACT, BUT SUCH FEARS HAVE BEEN ALMOST COMPLETELY ELIMINATED BY NOW, AND THEY ARE MORE WILLING TO ACCEPT THE YEN'S APPRECIATION --PROVIDED IT IS GRADUAL--SINCE THEY HAVE COME TO REALIZE THAT ITS FAVOURABLE EFFECTS ON PRICES WILL ULTIMATELY LEAD TO A SUBSTAINABLE GROWTH.

IV. CONCLUSIONS

- WE ARE SOMETIMES ACCUSED OF TRYING TO KEEP THE YEN AT AN ARTIFICIALLY LOW RATE TO PROMOTE EXPORTS. NOTHING IS FURTHER FROM THE TRUTH, AS I HOPE THIS ARTICLE HAS MADE CLEAR. THE YEN RATE IS A VERY IMPORTANT VARIABLE THAT WE ALWAYS MONITOR CAREFULLY, AND OUR AIM IS TO MAINTAIN GOOD "FUNDAMENTALS" AND TO ACCEPT--OR EVEN WELCOME--

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THE RESULTANT APPRECIATION OF THE YEN. WE SINCERELY WISH TO SEE A STRONGER YEN AND ARE FIRMLY DETERMINED TO PROTECT THE YEN FROM UNDUE DEPRECIATION.

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- I AM ENTIRELY IN AGREEMENT WITH DR. ZIJLSTRA WHEN HE SAYS, PARAPHRASING WALTER BAGEHOT, "EXCHANGE RATES WILL NOT MANAGE THEMSELVES," AND "EXCHANGE RATES ARE TOO IMPORTANT TO BE LEFT ALONE." A CENTRAL BANK, AS "THE GUARDIAN OF THE INTEGRITY OF MONEY," CAN NEVER FULFILL ITS MISSION OF MAINTAINING THE DOMESTIC VALUE OF ITS CURRENCY WITHOUT MAKING EVERY EFFORT TO DEFEND ITS EXTERNAL VALUE.

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END TEXT.
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END OF MESSAGE

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